

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105**

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INITIAL STATEMENT OF REASONS

INTRODUCTION

California Insurance Commissioner John Garamendi (Commissioner) will hold a public hearing to discuss the proposed addition of sections 2355.1 through 2359.7 to Title 10, Chapter 5, Subchapter 3, Article 7.1 of the California Code of Regulations. Additionally, the Commissioner seeks to amend Title 10, Chapter 5, Subchapter 3, Article 14 of the California Code of Regulations. The proposed regulations will interpret the provisions of Division 2, Part 6, Chapter 1 of the California Insurance Code, entitled "Title Insurance."

These regulations are authorized by Insurance Code sections 12401.3 and 12401.5 which permit the Commissioner to collect financial data and to maintain effective regulation over the title insurance marketplace to prevent excessive title insurance rates.

SPECIFIC PURPOSE AND NECESSITY OF THE REGULATIONS

As the Insurance Code provides in section 12401, the purpose of the proposed regulations is "to promote the public welfare by regulating rates for the business of title insurance...to the end that they shall not be excessive..." Recognizing the need to preserve and encourage competition, the proposed regulations reflect the Commissioner's determination that competition is lacking with respect to four phases of the business of title insurance. With the goal of invigorating market forces and returning a reasonable degree of competition to the business of title insurance, the Commissioner has developed a detailed system of regulation to eradicate excessive title and escrow rates in California. Under the present environment, the title insurance market is structurally incapable of promoting competition that protects consumers and ensures rates are reasonable in relation to the cost of providing the relevant services.

The California title insurance and escrow markets are characterized by reverse competition. Specifically, title insurers do not market their services directly to home buyers and instead market their services to other entities in the real estate transaction who are able to refer the home buyer to a particular title insurance or escrow provider. This market structure results in increased costs as title insurers use revenue from excess rates to provide considerations to the referrers of title and escrow business. The increased costs of this marketing structure do not benefit the home buyer and unnecessarily increase the cost and price of title insurance and escrow services. The proposed regulations address these market failures by mandating maximum rates that can be charged, while allowing title insurance companies, underwritten title companies and controlled escrow companies to charge lower rates if they wish.

The proposed regulations forbid the use of excessive rates through a formulaic evaluation of the rates charged by entities engaged in the business of title insurance. The Commissioner's proposed regulations contemplate a detailed inspection of the costs associated with the business of title insurance, and account for changes in the housing economy – which is the ultimate determinant of demand for title and escrow services – as well as changes in the cost of providing services associated with title insurance and escrow transactions. The proposed regulations evaluate the rates and premiums for charges associated with the business of title insurance by establishing a maximum permitted rate for various title and escrow products and services. Any rate or charge which exceeds the maximum rate necessarily reflects a rate or charge that is excessive and therefore prohibited.

One of the concepts behind the establishment of a reasonable maximum rate or charge for title insurance or escrow is that a significant amount of title and escrow expenses are fixed while revenue, which is dependent upon the number and size of real estate transactions, is volatile. Some contend that the title insurance industry incurs essentially the same cost of maintaining a title plant regardless of how many title policies are issued during the year.

Based upon this contention, some argue for the need to establish rates at a level that covers fixed costs even during a period of time when a small number of transactions take place. The problem with this approach is that rates which provide a reasonable profit during such a period are excessive during periods of moderate or great real estate activity. The extra revenue – not needed to cover the costs of providing the product – is used for reverse competitive behavior of giving considerations to the referrers of business.

Consequently, the proposed rate formula is responsive to fixed costs, the potential for changing volume of business and reverse competition. The maximum rate formulae in the regulation address these concerns by making the maximum rate responsive to changing real estate conditions while accounting for reasonable fixed costs and capping those expenses susceptible to reverse-competitive inflation.

The formulae address the problem of changing transaction and premium volume by relating the projected fixed expenses to projected number of transactions and by relating projected expenses that vary with number and size of transactions to projected amount of insurance. If the number of transactions were expected to decline from the historical expense period to the period the rates will be in effect, the projected fixed expenses per transaction would increase. Stated differently, the rate formulae – which establish maximum charges for an individual transaction of specific size (e.g., amount of insurance or size of escrow transaction) – would increase the fixed expenses per transaction if transactions are expected to decrease and decrease the fixed expenses per transaction if transactions are expected to increase greater than the adjustments for inflation and productivity.

Similarly, for expenses that vary with the number and size of transactions, the projected expenses will be related to the number and size of expected transactions – the projected amount of insurance or the projected amount of escrow. If the number or size of transactions is expected to increase significantly, the amount of expenses per dollar of insurance or escrow used in the

maximum charge formulae will be smaller than the historical expense per dollar of insurance or escrow.

While the concept behind the rate regulation is quite simple – the maximum charge for title insurance and escrow is responsive to changes in real estate activity and accounts for fixed and variable expenses – the rate regulation is lengthy because it contains a complete statistical plan and instructions for reporting of financial data with sufficient detail to introduce historical experience into the maximum rate formula and to enable the statistical agent to perform extensive quality review of the data. The rate regulation is also lengthy because it includes a large number of definitions – of terms and calculations – to make clear to the public the precise calculation of data totals provided by the statistical agent and used in the maximum rate formulae.

The rate regulation can be summarized and distilled to the following five equations. The first equation is for the maximum charge for a title insurance policy of a stated amount of insurance. That charge is the sum of the maximum charges for a preliminary report and a title policy issuance. A maximum charge is established for a preliminary report because it is a discrete product in the business of title insurance and a major portion of the activity associated with issuing a title insurance policy. The total costs for issuing a title insurance policy are those of the preliminary report plus the additional expenses associated with issuing and maintaining the policy, including the settlement of claims.

Maximum Title Insurance Policy Charge for a Stated Amount of Insurance equals (Maximum Preliminary Report Charge plus Maximum Title Policy Issuance Charge) / Premium Tax Gross Up.

The remaining four maximum rate formulae – preliminary report, title policy issuance, full escrow and subescrow – use the same general formula with different inputs based on historical expenses and projections:

Maximum Charge for a Stated Amount of Insurance or Escrow equals (Projected Fixed Expense per Projected Transactions Plus Projected Expenses That Vary with Amount of Insurance or Escrow Per Projected Amount of Insurance or Escrow) Divided by 1 – Provisions for Expenses That Vary with Premium or Charge

Projected amount of insurance or escrow is this historical amount of insurance adjusted for expected changes in the average transaction size during the period the rates will be in effect.

The rate regulation protects consumers by eliminating excess expenses due to reverse competition and requiring lower rates during periods of greater real estate activity.

The rate regulation protects insurers and underwritten title companies by allowing higher rates during periods of lessened real estate activity, by taking into account fixed expenses and the smaller number of transactions.

The rate regulation ensures that, in the absence of a reasonable degree of competition, rates are reasonable in relation to costs of providing the products and services.

The proposed regulations are divided into 5 subarticles. Subarticle 1 of the proposed regulations presents a series of general definitions and provisions for use in connection with the regulations. Subarticle 2 sets forth a uniform and comprehensive system for reporting data to the Commissioner for use in reviewing and evaluating individual rate filings. Subarticles 3 and 4 establish the methodology for testing whether an individual title insurance rate or escrow charge is excessive. Finally, subarticle 5 details the manner in which the Commissioner will review rate filings and new title products as well as enforce the prohibition against excessive rates.

The specific purpose of each provision and the rationale for the Commissioner's determination that each provision is reasonably necessary to carry out the purpose for which it is proposed are set forth below. Implementation of these regulations is necessary for effective rate review of the title insurance marketplace and to enforce the prohibition against excessive rates, as provided in Insurance Code sections 12401.3 and 12401.5.

Subarticle 1: General Provisions and Definitions

Section 2355.1 and 2355.2 identify the purpose and scope of the proposed regulations, which apply to all entities that conduct the business of title insurance within the meaning of Insurance Code section 12340.3.

Section 2355.3 sets forth a series of working definitions for terms used throughout the proposed regulations. The definitions apply to both the financial reporting requirements as well as the formulas applicable to the determination of excessive rates.

Section 2355.4 establishes a series of "projection values," which are factors intended to capture the effect on the companies' costs of forces such as inflation, changes in labor productivity and, in particular, changes in business volume and average transaction size. As explained above, the proposed regulations recognize and account for the fact that the demand for title insurance and escrow services is largely a function of the extent of real estate activity at a given point in time. The proposed regulations and applicable formulae protect those entities engaged in the business of title insurance by authorizing higher rates during periods of lessened real estate activity. Conversely, the proposed regulations also protect consumers by prohibiting higher rates during periods of increased real estate activity. Section 2355.4 focuses upon the cyclical nature of title insurance and operates to ensure that the threshold for excessive rates responds to cover downturns, for example, that leave companies with fewer transactions over which to spread their fixed costs. Just as in a competitive market, the proposed regulations assume that as costs and business activity rise and fall, companies will adjust their prices to make sure they recover their costs and make a reasonable profit but do not charge excessive, non-competitive rates.

Section 2355.5 implements the requirement in Insurance Code section 12401.5, that the Commissioner designate one or more advisory organizations to assist in the development of the statistical plan and to assist in gathering and compiling data. The Commissioner proposes to designate two advisory organizations. One organization will perform the traditional functions of a statistical agent, assisting with the processing of information to be submitted to the Department

of Insurance. To provide broader advice and service to the Commissioner, a second advisory organization, denominated the "statistical adviser," will provide the Commissioner with independent advice regarding the data compiled and collected.

Section 2355.6 formally declares the Commissioner's finding after reviewing the Competition Report and public materials in response to that report: that a reasonable degree of competition does not exist in the four phases of the business of title insurance. Specifically, the Commissioner has found that a reasonable degree of competition does not exist for 1) the title search, examination and commitment phase, 2) the policy issuance and servicing phase, 3) the escrow and closing phase, and 4) other services phase of the title insurance transaction.

Subarticle 2: Statistical Plan and Financial Reporting Requirements for Title Insurers, Underwritten Title Companies and Controlled Escrow Companies

Sections 2356.1 through 2356.6 generally identify the entities required to report financial data pursuant to the statistical plan, what reports must be generated, when the reports must be generated, how to generate the reports and where to submit the reports.

Section 2356.7 describes the method by which the Commissioner will ascertain whether the data reported meets acceptable standards in terms of quality, form and accuracy.

Section 2356.8 sets forth the detailed reporting requirements for title insurers.

Section 2356.9 sets forth the detailed data reporting requirements for underwritten title companies. While the reports submitted by underwritten title companies pursuant to Insurance Code section 12389 are similar, the reports are not identical. Thus, underwritten title companies are advised to avoid reliance upon any similarities between the two reporting methodologies when submitting reports in accordance with section 2356.9.

Subarticle 3: Regulation of Rates for Title Insurance

Section 2357.1 identifies the segment of the title insurance marketplace to which the rate regulation provisions apply. The formulaic inspection of title rates under the proposed regulations is limited to preliminary reports and title insurance policies for residential properties.

Section 2357.2 describes the nature of the maximum threshold for title insurance rates. Rates which exceed this threshold are rates the Commissioner has conclusively established to be excessive. To the extent that a title entity wishes to charge a rate that is less than or equal to this threshold, the proposed regulations do not restrict an entity's ability to do so, other than to prohibit rates that are otherwise in violation of law.

Section 2357.3 provides for the determination of "title insurance totals." These totals are aggregations calculated from the financial data submitted pursuant to the statistical plan. The totals are simple summations, and will only be altered to correct for missing or erroneous data.

Section 2357.4 establishes the process for the determination of "projected values" for the projections defined in subarticle 1. These projected values are derived from the statistical plan's

totals, in consultation with the advisory organizations, to develop future unit costs for use in the ratemaking formula.

Section 2357.5 represents the formulaic definition of the maximum title insurance charge for a policy. This formula takes into account all of the class relativities and endorsement factors that are applicable to a given policy. In contrast to section 2357.6, section 2357.5 establishes the regulation of rates on a policy-specific basis. This formula is necessary because a maximum rate is established by the amount of insurance, discounts and surcharges for the preliminary report and by amount of insurance, discounts, surcharges and endorsements for the policy form.

Section 2357.6 is designated the "maximum average title insurance charge" which is the basic rate-regulation formula, defining the maximum charge, above which the rate is determined to be excessive. Stated another way, this charge may be thought of as the base rate, before any modifications for policy forms and endorsements. This formula reflects the reasonable costs, including capital costs, of providing title insurance, were there a competitive market.

Section 2357.7 establishes the formula for the preliminary report charge. This provision, like the regulations generally, will ensure a rate that gives each company the opportunity to cover its reasonable costs, including a reasonable profit to provide a necessary return on invested capital. The preliminary report charge is established both as a discrete product and as a portion of the title insurance policy charge. A discrete charge for a preliminary report is provided for in the regulations because the Insurance Code contemplates that the party ordering the report will typically be charged. (Ins. Code § 12404.1.) While the activities associated with a preliminary title report – search, exam, underwriting – are typically associated with work performed by an underwritten title company as opposed to a title insurance company, the preliminary report charge is not intended to represent the portion of premium going to a UTC. Indeed, the Commissioner recognizes that underwritten title companies and title insurance companies perform activities associated with both the preliminary report and the title policy charge. The allocation of expense categories to preliminary report charge and title policy issuance are based on functional activities associated with these products and not based on which type of entity performs specific activities. The regulations do not specify the allocation of premiums between underwritten title companies and title insurers. Title insurers and underwritten title companies remain free to negotiate any split of premium they desire.

Section 2357.8 defines the profit factor. In light of the Commissioner's determination that the title insurance marketplace is non-competitive, the profit factor is not based upon the title industry's current rate of return. Because of reverse competition, excess revenue that might otherwise show up as profit is reported as an expense associated with the provision of free services to the referrers of title and escrow business in exchange for these referrals. Instead, the profit factor is based upon historic profit levels of insurance companies from other insurance lines and represents the return on capital necessary to attract capital to the business of title insurance.

Section 2357.9, the maximum rate of return, divides the required return into the risk-free rate and the risk premium. Due to the similarity of the products and the fact that title insurance risks are typically less than the risks associated with the property-casualty business, the Commissioner has

selected the property-casualty industry experience as a reasonable basis for determining the risk premium for title insurance. The long-term risk premium of 3 ³/₄ percent represents the long-term average by which book returns of property-casualty insurers have exceeded the risk free rate.

Section 2357.10 sets forth the capitalization ratio, which recognizes that companies are entitled to a reasonable return on the capital that is used and useful to provide title insurance. The ratio reflects the amount of capital that has been held by companies providing title insurance in recent years. The regulations recognize both the amount of capital held by title insurers and underwritten title companies devoted to supporting title premium.

Section 2357.11 provides the state and federal income tax factor. Unlike the profit factor, section 2357.11 accepts the historic industry-average income tax rates as the expected percentages of profit to be collected for income taxes going forward. Both state and federal tax rates assess income taxes as a percentage of income. The Commissioner has determined, however that taxes actually paid by companies do not closely follow these nominal tax rates, and therefore this section specifies that income taxes are to be measured by the companies' effective tax rates over the preceding three-year period.

Section 2357.12, the investment income factor, is determined from industry experience, as a function of industry capital, over ten years for capital gains and over three years for other income.

Section 2357.13 establishes the sales cost factor, which is derived from a review of benchmark figures from other financial-services markets. Based upon his review, the Commissioner has determined that the most appropriate businesses are the property-casualty insurance industry. The sales cost factor cannot be derived from the title insurance and escrow markets, because the Commissioner has found that the absence of a reasonable degree of competition in the title insurance marketplace has resulted in reverse-competitive pressures that, in turn, prevent the use of actual historical sales costs as reasonable sales costs.

Section 2357.14 designates the maximum policy charge. This charge is set forth, conceptually, in the same fashion as the preliminary report charge in section 2357.7. This section excludes the costs associated with the title-search component, because those costs are covered in the preliminary report charge. As mentioned above in section 2357.7, the division of activities between the policy charge and the preliminary report charge are not intended to reflect the true division of activities. The title insurer and underwritten title company remain free to negotiate the appropriate division of such activity.

The numerator identifies the average costs for policy issuance and maintenance and for taxes, licenses, and fees on a per-transaction basis. The numerator also specifies the average costs for losses and for overhead as a function of the policy amount. The denominator, on the other hand, is identical to the denominator of the preliminary report charge with one exception. Because state income taxes do not apply to underwriting, there is no allowance for state income taxes in section 2357.15.

Section 2357.15 establishes the federal income tax factor, which does not include a calculation for state income taxes for the reasons set forth directly above.

Section 2357.16 recites the statutory premium tax rate of 2.35 percent.

Section 2357.17, the retention rate, applies elements of the statistical plan to determine the portion of the premium subject to the state premium tax, rather than the state income tax.

Section 2357.18 presents the universe of relativities for policy forms in use in California. The established relativities were developed based upon a review of representative rate filings.

Section 2357.19 provides for the manner in which endorsements may be used by a title insurer. While a title insurer may use any endorsement factor it chooses, such endorsements must not result in a policy charge that exceeds the maximum title insurance charge or interim-maximum rate, as provided in sections 2357.5, 2357.20 and 2358.8.

Section 2357.20 provides an immediate means for lowering extant excessive rates. While a statistical plan will soon provide the data necessary to determine the reasonable costs upon which the maximum permitted rates will be based in the future, the Commissioner recognizes that rates set today are already above the levels that would have existed in a competitive market. These regulations, therefore, provide for an interim rate reduction designed to offset just one aspect of a non-competitive market; non-cost-based rates.

Current rate filings, many of which have been in effect since 2000, set the rate for title insurance primarily as a percentage of the exposure or policy amount. The price of residential real estate has risen by 48 percent in California between 2000 and 2005. The rise in the price of real estate, therefore, has resulted in a premium increase of 29% simply due to the increase in home values. This, despite the fact that the cost of providing title insurance does not vary substantially according to the amount of insurance purchased. This section, therefore, adjusts for those costs that do increase with exposure, such as expected losses, and for costs that increase over time, such as price inflation and provides for an interim rate reduction to 84 percent of what was charged for the same policy on the same property in 2000 for refinancings and to 77 percent of what was charged for the same policy on the same property in 2000 for all other policies.

Section 2357.20 does not address any other aspects of excessive rates. This provision merely offsets the increase in costs attributable to increased housing costs since year 2000, while allowing for increases in expenses due to inflation.

Subarticle 4: Regulation of Rates for Escrow Services

Section 2358.1 identifies the segment of the title insurance marketplace to which the rate regulation provisions apply. The formulaic inspection of escrow charges under the proposed regulations is limited to residential dwellings.

Section 2358.2 describes the nature of the maximum threshold for escrow charges. Charges which exceed this threshold are charges the Commissioner has conclusively established to be excessive. To the extent that an escrow entity wishes to charge an amount that is less than or

equal to this threshold, the proposed regulations do not restrict an entity's ability to do so, other than to prohibit charges that are otherwise in violation of law.

Section 2358.3 establishes calculated and corrected totals for certain components of the escrow formula charge. The totals are based upon consultation with the advisory organizations and related data received pursuant to the statistical plan.

Section 2358.4 establishes the process for the determination of "projected values" for various escrow functions. These projected values are derived from the statistical plan's totals, in consultation with the advisory organizations, to develop future unit costs. The projected values, in turn, will operate as factors within the maximum escrow charge formula.

Section 2358.5 represents the maximum escrow charge for a transaction. In contrast to section 2358.6, section 2358.5 establishes the regulation of rates on a transaction-specific basis. This formula is necessary because the regulation of escrow charges will also be performed on a transaction-specific basis.

Section 2358.6 provides the maximum average escrow charge. This formula operates in a manner that is analogous to the maximum average title insurance charge in section 2357.6. Thus, document production, execution and funds transfer costs are projected on a per-transaction basis. Profit, investment income and sales costs are calculated as a percentage in the denominator of the formula. Escrow rates are a function of variable and fixed costs. The variable costs are captured by cost functions that vary with transaction size. The fixed costs are captured by cost functions that are a fixed cost per transaction. The maximum average escrow charge is adjusted for escrow relativities in a subsequent calculation.

Section 2358.7 displays the various escrow relativities and the assigned relativity value for each. Like the endorsements for title insurance, the relativities for escrow were derived from representative filings that were filed with the Department. While a controlled escrow company is permitted to use any relativity it chooses, the ultimate charge for the transaction cannot exceed the maximum escrow charge as defined in section 2358.5 and also cannot exceed any interim maximum rate as defined in sections 2357.20 and 2358.8.

Section 2358.8 presents the interim maximum rates for escrow charges. The interim maximum rates for escrow are calculated in a similar fashion to the interim maximum rates for title insurance in section 2357.20. These regulations, therefore, provide for an interim rate reduction designed to offset just one aspect of a non-competitive market; non-cost-based rates. The interim maximum rate for escrow will remain operative until such time as the Commissioner receives sufficient information from the statistical plan to determine and publish all of the projection factors in section 2358.4 and the total projected values in section 2358.3.

Subarticle 5: Enforcement

Section 2359.1 identifies the form and contents of a rate filing that will be the required components of any title rate filed with the Department. This section notifies title entities that incomplete filings will be rejected and establishes public nature of rate filings.

Section 2359.2 sets forth the consequences which attend any title insurance or escrow charge filing that is in excess of the maximum permitted title premium or maximum permitted escrow charge. This section also identifies that any title entity's failure to refund and reduce a title insurance rate or escrow charge after receipt of a notice of noncompliance or order finding a rate violation is by definition willful within the meaning of Insurance Code sections 12414.16 and 12340.9.

IDENTIFICATION OF STUDIES RELIED UPON

Birny Birnbaum, "Report to the Insurance Commissioner: An Analysis of Competition in the California Title Insurance and Escrow Industry" (December 2005).
Staff Report, "Calculation of Interim Maximum Rates" (July 3, 2006).

SPECIFIC ACTIONS, PROCEDURES, TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

REASONABLE ALTERNATIVES

The Commissioner has identified no reasonable alternatives to the presently proposed regulations. The Commissioner has determined that no reasonable alternatives exist to carry out the purpose for which the regulations are proposed. Performance standards were considered but were rejected as an unreasonable and impracticable alternative. Nevertheless, the Commissioner invites public comments on the proposed changes and reasonable alternatives which would be as effective to carry out the proposed changes.

ECONOMIC IMPACT ON SMALL BUSINESS

The Commissioner has not identified any alternatives that would lessen any adverse impact on small businesses. Nor have any such alternatives otherwise been identified and brought to the attention of the Commissioner that would lessen any impact on small business. Nevertheless, the Commissioner invites public comments on the proposed changes and reasonable alternatives which would be as effective to carry out the proposed changes. To the extent that the proposed regulations affect insurance companies, financial institutions, subdividers, developers, and services where the annual gross receipts for the business exceed two million dollars, the proposed regulations do not affect small business. (See Gov. Code § 11342.610.)

FINDING OF POSSIBLE SIGNIFICANT ADVERSE ECONOMIC IMPACT ON BUSINESS

The proposed regulations require title insurance entities to collect and report financial data to the Commissioner in a structured, detailed format. Additionally, to the extent that a title insurance rate exceeds the maximum rate as calculated by the proposed regulations, the regulations may result in a reduction in the rates that a title insurer, underwritten title company or controlled escrow company may charge. The regulations also require title insurance and escrow rates to be reduced to levels reflecting the housing costs in year 2000. The Commissioner recognizes that

each of these proposed changes may have a significant adverse economic impact on business.

Title insurers, underwritten title companies and controlled escrow companies are already required to report financial data to the Commissioner. The proposed regulations identify uniform standards and categories of data for collection and reporting in the future. While entities engaged in the business of title insurance can expect some economic impact due to the new reporting requirements imposed by the proposed regulations, the costs for compliance will be modest in light of the costs already incurred by title entities in complying with current collection and reporting requirements.

Insofar as the proposed regulations identify the maximum permitted title and escrow charge that falls below an excessive rate, the economic impact will affect title and escrow entities in a uniform manner, as all title entities will be subject to the same standard for excessive rates. Similarly, while the proposed regulations require a reduction in title and escrow rates to levels observed in year 2000, the economic impact will apply uniform standards to all title entities. The proposed regulations, over time, will enable entities engaged in the business of title insurance to become more efficient and competitive with respect to the costs associated with providing services and marketing of title and escrow products. If one were to assume, for example, that the proposed regulations will reduce title and escrow expenditures by 20%, or \$800 million, the resulting savings in expenses will further a competitive and more efficient market.

The Commissioner, therefore, has determined that the proposed regulations may have a significant adverse economic impact on businesses subject to the proposed regulations.